15 Itemized Deduction for Interest Expenses

	See ¶
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On Schedule A, you may deduct three types of interest charges:

- Home mortgage interest,
- Points, and
- Investment interest

These deductions are also subject to limitations:

- Home mortgage interest and points are subject to the 3% reduction of itemized deductions if your adjusted gross income (AGI) exceeds $117,950 ($58,975 for married persons filing separate returns).
- Investment interest is deductible only up to the amount of net investment income but is not included in the 3% reduction computation. The 3% reduction rule is discussed at ¶13.8.

Interest on personal loans (such as loans to buy autos and other personal items and credit card finance charges) is no longer deductible.

Interest on loans for business purposes is fully deductible on Schedule C.

Interest on loans related to rental property is fully deductible from rental income on Schedule E. Whether interest is a business, investment, or a personal expense generally depends upon the use made of the money borrowed, not on the kind of property used to secure the loan. However, interest on a loan secured by a first or second home may be deductible as home equity mortgage interest regardless of how you use the loan.

Passive activity interest. Interest on loans used to finance an investment in a passive activity is subject to the limitations of Chapter 10. However, if you rent out a second home that qualifies as a second residence, the portion of mortgage interest allocable to rental use is deductible as qualified mortgage interest and is not treated as a passive activity expense.

¶15.1 Home Mortgage Interest

You generally may deduct on Schedule A (Form 1040) qualifying mortgage interest on up to two residences (*see* two-residence limit below). However, if your 1996 adjusted gross income exceeds $117,950 ($58,975 if married filing separately), your mortgage interest deduction is subject to the 3% reduction of itemized deductions; *see* ¶13.8.

Mortgage loan obtained after October 13, 1987. Whether you can take a full mortgage interest deduction for a loan taken out after October 13, 1987, depends on the amount of the mortgage debt and how you use the proceeds. Loans used to buy, construct, or improve a first or second home are called *home acquisition loans*, and up to $1 million of such debt qualifies for a mortgage interest deduction, $500,000 if married filing separately. Loans used for any other purpose are called *home equity loans* by the tax law, and up to $100,000 of such debt qualifies for an interest deduction; the home equity limit is $50,000 for married persons filing separately.

To deduct interest on a home acquisition or home equity loan, the loan must be *secured* by your main home or a second home. For the loan to be "secured," it must be recorded or satisfy similar requirements under state law. For example, if a relative gives you a loan to help you purchase a home, the relative must take the legal steps required to record the loan with local authorities; otherwise, you may not deduct interest on the loan.

Home acquisition loans are further discussed at ¶15.2. *Home equity loans* are discussed ¶15.3.

If you *refinance* your mortgage, *see* ¶15.7.

Mortgage loan obtained before October 14, 1987. You may deduct all of the interest on a loan secured by a first or second home if the loan was obtained before October 14, 1987. Technically, such loans are considered home acquisition debt, but they are treated as "grandfathered debt" exempt from the $1 million loan limit ($500,000 for married persons filing separately).

However, the amount of your pre-October 14, 1987, loan reduces the $1 million limit (or $500,000) on home acquisition debt after October 13, 1987; *see* ¶15.2. It also reduces the fair market value limit for home equity debt; *see* ¶15.3. If you *refinance* your loan, *see* ¶15.7.

Two-residence limit for qualifying mortgage debt. The rules for deducting qualifying acquisition debt or home equity debt apply to loans secured by your principal residence and one other residence. A residence may be a condominium or cooperative unit, houseboat, mobile home, or house trailer that has sleeping, cooking, and toilet facilities. If you own more than two houses, you decide which residence shall be considered your second residence. Interest debt secured by the second residence is deductible under the rules for acquisition debt (¶15.2) or home equity debt (¶15.3).

A residence that you rent out for any part of the year may be treated as a second residence only if you use it for personal nonrental purposes for more than the greater of 14 days or 10% of the rental days. In counting rental days, include days that the home is held out for rental or listed for resale. In counting days of personal use, use by close relatives generally qualifies as your personal use; *see* ¶9.6.

Interest on debt secured by a residence other than your principal or second home may still be deductible, if you use the proceeds for investment or business purposes; *see* ¶15.12.

Interest on mortgage credit certificates. Under special state and local programs, you may obtain a "mortgage credit certificate" to finance the purchase of a principal residence or to borrow funds for certain home improvements. Generally, a qualifying principal residence may not cost more than 90% of the average area purchase price, 110% in certain targeted areas. A tax credit for interest paid on the mortgage may be claimed. The credit is computed on Form 8396 and claimed on Line 42 of Form 1040. The credit equals the interest paid multiplied by the certificate rate set by the governmental authority but the maximum annual credit is $2,000. Interest not qualifying for the credit is deductible as home mortgage interest.

EXAMPLE

You pay $5,000 interest for a mortgage issued under a qualifying mortgage credit certificate. Under its terms, you are allowed a tax credit of $750. You may claim the balance of your mortgage interest, or $4,250 ($5,000 – $750), as an itemized deduction. If the allowable credit exceeds tax liability, a three-year carryover is allowed.

If you buy a home using a qualifying mortgage credit certificate and sell that home within nine years, you must recapture part of the tax credit on Form 8828.

¶15.2 Home Acquisition Loans

Under the mortgage interest rules, a qualifying "home acquisition loan" is a loan used to buy, build, or substantially improve your principal residence or second home, provided the debt is secured by that same residence.

Interest paid on such home acquisition loans is fully deductible if the total debt does not exceed $1,000,000, or $500,000 if you are married filing separately. The $1,000,000 (or $500,000) limit applies to acquisition loans taken out after October 13, 1987.

If your mortgages, taken after October 13, 1987, exceed the $1,000,000 (or $500,000) limit, you must use IRS worksheets included in Publication 936 to figure the amount of your deductible interest. Furthermore, if you incurred substantial pre-October 14, 1987, loans and later purchase a new home, your deduction for the

mortgage for the new home may be limited. The $1 million limit for acquisition debt after October 13, 1987, is reduced by the amount of outstanding pre-October 14, 1987, debt.

Although interest on a pre-October 14, 1987, debt is generally fully deductible regardless of the size of the loan, refinancing a pre-October 14, 1987, debt for more than the existing balance subjects the excess to the $1 million ceiling; *see* ¶15.7.

Generally, a debt qualifies as being incurred in buying, constructing, or improving a residence if you satisfy IRS tracing rules (¶15.12) that prove the use of the loan proceeds for such residential purposes. Even if you cannot prove under the tracing rules that a loan was used to buy a residence, a loan will be treated by the IRS as incurred for buying a house to the extent you can show acquisition expenses within 90 days before, or 90 days after, incurring the loan. Special construction loan and improvement loan rules are discussed in ¶15.4 and ¶15.5.

Interest on a mortgage to buy or build a home other than your principal residence or qualifying second home is treated as nondeductible personal interest. If a nonqualifying home is rented out, the part of the mortgage interest that is allocable to the rental activity is treated as passive activity interest subject to the limitations of Chapter 10; the interest allocable to your personal use is nondeductible personal interest.

A married couple filing jointly may designate as a second residence a home owned or used by either spouse.

If a married couple files separately, each spouse may generally deduct interest on debt secured by one residence. However, both spouses may agree in writing to allow one of them to deduct the interest on a principal residence plus a designated second residence.

Cooperatives. In the case of housing cooperatives, debt secured by stock as a tenant-stockholder is treated as secured by a residence. The cooperative should provide you with the proper amount of your deductible interest. If the stock cannot be used to secure the debt because of restrictions under local law or the cooperative agreement, the debt is still considered to be secured by the stock if the loan was used to buy the stock. For further details on allocation rules, *see* IRS Publication 936.

Line-of-credit mortgages. If you had a line-of-credit mortgage on your home on October 13, 1987, and you borrowed additional amounts on this line of credit after that date, the additional borrowed amounts are treated as a mortgage taken out after October 13, 1987. If the newly borrowed amounts are used to buy, build, or improve your first or second home, they are treated as home acquisition debt subject to the $1 million or $500,000 limit. If used for any other purpose, the amounts are subject to the home equity debt rules at ¶15.3.

Mortgage interest paid after house destroyed. If your principal residence or second home (¶15.1) is destroyed and the land is sold within a reasonable period of time following the destruction, the IRS treats the property as a residence for purposes of deducting interest payments on the mortgage during the period between the destruction of the residence and the sale of the land. In one case, the IRS allowed the interest deduction where a sale of land took place 26 months after the destruction of a home by a tornado.

If the destroyed residence is reconstructed and reoccupied within a reasonable period of time following the destruction, the property will continue to be treated as a residence during that period, and the interest payments on the mortgage on the property will be deductible. The IRS allowed an interest deduction where reconstruction began 18 months after, and was completed 34 months after, destruction of the home.

Mortgage Fees Not Deductible

You may not deduct expenses incurred in obtaining a mortgage such as commissions, abstract fees, or recording fees. These fees become part of the cost basis of your home; when you sell, they reduce your taxable gain.

¶15.3 Home Equity Loans

For interest deduction purposes, qualifying home equity debt is the *lesser* of:

1. $100,000, or $50,000 if married filing separately, *and*
2. The fair market value of your principal residence and second home, *reduced* by the amount of acquisition debt (¶15.2) and by any "grandfathered" pre-October 14, 1987, mortgages(¶15.1). According to the IRS, fair market value, acquisition debt, and grandfathered debt are determined on the date that the last debt was secured by the home.

The debt must be secured by your first or second home to qualify. If you have a second home as well as a principal residence, the above limitation under (1) and (2) applies to the total debt for both houses. Interest on a qualifying home equity loan is deductible regardless of the way you spend the proceeds, unless it is used to buy tax-exempts (¶15.11).

On loans exceeding the home equity debt limit, interest may be deductible if the proceeds are used for investment or business purposes. Otherwise, interest on the excess is nondeductible personal interest.

EXAMPLES

1. You bought your house in 1986 for $200,000 subject to a mortgage of $150,000. When the mortgage principal is $120,000 and the fair market value of the house is $210,000, you take out a home equity loan. Interest on a home equity loan of up to $90,000 is fully deductible. Qualifying home equity debt may not exceed the difference between the fair market value of the house ($210,000) and the current acquisition debt ($120,000). If the value of the house exceeded $220,000, you could have borrowed up to the $100,000 limit as a qualifying home equity loan.
2. The fair market value of your house is $200,000 and the current mortgage is $160,000. You may deduct interest on a home equity loan of up to $40,000 ($200,000 – $160,000).

A loan may qualify partially as acquisition debt and partially as home equity debt where part of it is used to refinance an existing acquisition debt. The refinanced amount is still considered acquisition debt. Debt in excess of the refinanced amount is either home equity debt subject to the $100,000 ceiling or home acquisition debt subject to the $1 million ceiling, depending on how the proceeds are used*; see* ¶15.7.

Home Equity Loan To Pay Consumer Debts

Interest on consumer loans is not deductible, but you can use a home equity line-of-credit mortgage to pay off existing consumer debts and finance future consumer expenses. However, although interest on a home equity loan is fully deductible for regular tax purposes if within the $100,000 limit, the interest is not allowed for purposes of alternative minimum tax, unless used to improve your first or second home; *see* ¶23.5.

¶15.4 Home Construction Loans

Interest on a home construction loan may be fully deductible from the time construction begins for a period of up to 24 months while construction takes place. Within the 24-month period, the loan is considered acquisition debt subject to the $1 million ceiling (¶15.2), provided that the home is a principal residence or second home when it is actually ready for occupancy. Furthermore, the loan proceeds must be directly traceable to home construction expenses, including the purchase of a lot, and the loan must be secured by the lot to be treated as acquisition debt. According to the IRS, if construction begins before a loan is incurred, the loan is treated as acquisition debt to the extent of construction expenses within the 24-month period *before* the loan. In determining when a loan is "incurred" for purposes of this 24-month rule, you can treat the date of a written loan application as the date the loan was "incurred," provided you receive the loan within 30 days after loan approval.

Interest incurred on the loan before construction begins is treated as nondeductible personal interest (*see* Example 1 below). If construction lasts more than 24 months, interest after the 24-month period also is treated as nondeductible personal interest.

Interest on loans taken out within 90 days *after* construction is completed may qualify for a full deduction. The loan is treated as acquisition debt to the extent of construction expenses within the last 24 months before the residence was completed, plus expenses through the date of the loan (*see* Example 2 below). For purposes of the 90-day rule, the loan proceeds generally are treated as received on the loan closing date. However, a debt may be considered "incurred" on the date a written loan application is made, provided the loan proceeds are actually received within 30 days after loan approval. If a loan application is made within the 90-day period and it is rejected, and a new application with another lender is made within a reasonable time after the rejection, a loan from the second lender will be considered timely even if more than 90 days have passed since the end of construction.

EXAMPLES

1. On January 12, 1996, you borrow $100,000 to buy a residential lot. The loan is secured by the lot. You begin construction of a principal residence on January 1, 1997, and use $250,000 of your own funds for construction expenses. The residence is completed December 31, 1998.

   The interest paid in 1996 is nondeductible personal interest. It was paid before the 24-month qualifying construction period which started January 1, 1997, and ended December 31, 1998.

   Interest paid in 1997 and 1998 is fully deductible as the $100,000 loan is treated as acquisition debt for the 24-month construction period.
2. Same facts as Example 1, but on March 17, 1999, you take out a $300,000 mortgage on the completed house to raise funds. You use $100,000 of the loan proceeds to pay off the $100,000 loan on the lot and keep the balance.

   All of the interest on the $300,000 loan is fully deductible because the loan qualifies as acquisition debt; $100,000 of the debt is treated as acquisition debt used for construction, since it was used to refinance the original 1996 debt to purchase the lot. The $200,000 balance is also treated as a construction loan under the 90-day rule. It was borrowed within 90 days after the residence was completed, and it reimbursed construction expenses of at least $200,000 incurred within 24 months before the completion date.
3. On January 12, 1996, you purchased a residential lot and began building a home on the lot using $45,000 of your personal funds. The home was completed on October 31, 1996. On November 29, 1996, you received a loan of $36,000 that was secured by the home. The debt may be treated as taken out to build the home as it was taken out no later than 90 days after the home was completed, and expenditures of at least $36,000 were made within the period of 24 months before the home was completed.

¶15.5 Home Improvement Loans

Loans used for substantial home improvements are treated as acquisition debt subject to the $1 million ceiling for loans after October 13, 1987; *see* ¶15.2. Include only the cost of home improvements that must be added to the basis of the property because they add to the value of the home or prolong useful life. Repair costs are not considered.

EXAMPLE

Your current acquisition mortgage is $100,000. You borrow $20,000 to build a new room. Your qualifying acquisition debt is now $120,000.

If substantial improvements to a home are begun but not completed before a loan is incurred, the loan will be treated as acquisition debt (assuming the debt is secured by the home) to the extent of improvement expenses made within 24 months before the loan. If the loan is incurred within 90 days after an improvement is completed, the loan is treated as acquisition debt (assuming the debt is secured by the home) to the extent of improvement expenses made within the period starting 24 months before completion of the improvement, and ending on the date of the loan.

¶15.6 Mortgage Payment Rules

Payments to the bank or lending institution holding your mortgage may include interest, principal payments, taxes, and fire insurance premiums. Deduct only interest and tax payments. You may not deduct the payments of mortgage principal and insurance premiums.

Mortgage Interest Reported on Form 1098

Banks and other lending institutions report mortgage interest payments of $600 or more to the IRS on Form 1098. You should receive a copy of Form 1098 or a similar statement by January 31, 1997, showing your mortgage payments in 1996. Deductible points (¶15.8) paid on the purchase of a principal home are included on Form 1098.

In the year you sell your home, check your settlement papers for interest charged up to the date of sale; this amount is deductible.

Mortgage credit. If you qualify for the special tax credit for interest on qualified home mortgage certificates, you only deduct interest in excess of the allowable credit; *see* ¶15.1.

Jointly owned property. When mortgaged property is jointly owned, a joint owner who pays the entire interest charge may deduct the amount of the entire payment.

Prepayment penalty. A penalty for prepayment of a mortgage is deductible as interest.

Mortgage assistance payments. You may not deduct interest paid on your behalf under Section 235 of the National Housing Act.

Delinquency charges for late payment. According to the IRS, a late payment charge is deductible as mortgage interest if it was not for a specific service provided by the mortgage holder. In one case, the Tax Court agreed with the IRS that delinquency charges imposed by a bank were not interest where they were a flat percentage of the installment due, regardless of how late payment was. The late charges were primarily imposed by the bank to recoup costs related to collection efforts, such as telephone calls, letters, and supervisory reviews. They were also intended to discourage untimely payments by imposing a penalty.

Joint Liability on Mortgage

If you do not personally receive a Form 1098 but a person (other than your spouse with whom you file a joint return) who is also liable for and paid interest on the mortgage received a Form 1098, you deduct your share of the interest and attach a statement to your Schedule A showing the name and address of the person who received the form. If you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, provide them with information on their share of the deductible amount.

Graduated payment mortgages. Monthly payments are initially smaller than under the standard mortgage on the same amount of principal, but payments increase each year over the first five- or 10-year period and continue at the increased monthly amount for the balance of the mortgage term. As a cash-basis taxpayer, you deduct the amount of interest actually paid even though, during the early years of the mortgage, payments are less than the interest owed on the loan. The unpaid interest is added to the loan principal, and future interest is figured on the increased unpaid mortgage loan balance. The bank, in a year-end statement, will identify the amount of interest actually paid. (An accrual-basis taxpayer may deduct the accrued interest each year.)

Reverse mortgage loan. Homeowners who own their homes outright may in certain states cash in on their equity by taking a "reverse mortgage loan." Typically, 80% of the value of the house is paid by a bank to a homeowner in a lump sum or in installments. Principal is due when the home is sold or when the homeowner dies; interest is added to the loan and is payable when the principal is paid. The IRS has ruled that an interest deduction may be claimed by a cash-basis homeowner only when the interest is paid, not when the interest is added to the outstanding loan balance.

Shared appreciation mortgage. Under a shared appreciation mortgage (SAM) for a personal residence, the lender agrees to charge a fixed rate of interest that is lower than the prevailing market rate. In return, the homeowner promises to pay a percentage of the appreciation on the property at a later date to make up the difference. The fixed-rate interest is deductible when paid and the percentage of appreciation is also treated as interest which you can deduct in the year of payment, subject to the limits of ¶15.2. For example, you agree to pay interest of 9% plus 40% of the appreciation in the value of the property within 10 years or earlier if you sell the house or pay off the mortgage. If, at the end of 10 years, the residence is not sold or the loan repaid, you may refinance at the prevailing rate the outstanding balance plus the interest based on the appreciation. If you refinance with the same lender, you may not claim an immediate deduction for the extra interest. The execution of a note is not considered payment. The amount covering the extra interest is deducted ratably over the period of the new loan. If you refinance with another lender and use the funds to pay off the old loan plus the extra interest, the extra interest is deductible in the year of payment, subject to the limits of ¶15.2.

Redeemable ground rents. These are deductible as mortgage interest if: (1) the land you lease is for a term exceeding 15 years (including renewal periods) and is freely assignable; (2) you have a present or future right to end the lease and buy the entire interest; and (3) the lessor's interest in the land is primarily a security interest. Payments to end the lease and buy the lessor's interest are not deductible ground rents.

¶15.7 Interest on Refinanced Loans

When you refinance a mortgage on a first or second home (¶15.1) for the same amount as the remaining principal balance on the old loan, there is no change in the tax treatment of interest. In other words, if interest was fully deductible on the old loan, then it is fully deductible on the new loan.

If you refinance a home mortgage for more than the existing balance, the deductibility of interest on the excess amount depends upon how you use the funds and the amount of refinancing. If the excess amount is used to buy, build, or substantially improve your first or second home, then it is considered home acquisition debt; *see* ¶15.2. If the excess plus all other home acquisition loans does not exceed $1 million ($500,000 if married filing separately), the interest is fully deductible. If the excess is used for any other purpose, such as to pay off credit card debt or to finance a child's education, the excess is considered home equity debt; *see* ¶15.3. If the excess plus all other home equity loans does not exceed $100,000 ($50,000 if married filing separately), the interest is fully deductible.

If the refinanced loan is partly home acquisition debt and partly home equity debt, the overall limit of $1.1 million applies ($1 million home acquisition debt and $100,000 home equity debt), or, if married filing separately, $550,000 ($500,000 home acquisition debt and $50,000 home equity debt).

Interest paid on loans in excess of home acquisition and home equity debt ceilings is generally treated as nondeductible personal interest unless the proceeds are used for business or investment purposes; *see* ¶15.12.

EXAMPLE

In 1991, Robert and Michelle Stein purchased a home for $250,000. They put $50,000 down and obtained a $200,000, 30-year mortgage secured by the home. In 1996, when their house is worth $300,000 and there is a $175,000 principal balance on the mortgage, they refinance to take advantage of lower interest rates. The refinanced mortgage is for $225,000, payable over 20 years. The Steins use $175,000 to pay off the old mortgage, $30,000 to purchase a car and to pay off credit card debt, and the remaining $20,000 to build a new deck on their home.

The interest on up to $175,000 of the debt incurred to pay off the old mortgage is fully deductible; the amount equals the outstanding balance before refinancing and also falls within the $1 million home acquisition debt ceiling. The $20,000 used to remodel the house is also treated as home acquisition debt. Interest on this amount is fully deductible; the amount falls within the $1 million ceiling when added to the $175,000.

The $30,000 used to buy a car and pay off credit cards is treated as home equity debt. Interest on this amount is fully deductible; the amount falls within the $100,000 ceiling.

Pre-October 14, 1987, loans. Refinanced pre-October 14, 1987, loans are not subject to the $1 million home acquisition and $100,000 home equity debt ceilings during the period of the original loan term. However, after the end of the original loan term, the ceilings apply to the refinanced amount as explained above. Furthermore, where a refinanced pre-October 14, 1987, debt exceeds the remaining principal balance, the excess is also subject to the $1 million home acquisition and $100,000 home equity debt ceilings.

EXAMPLE

In 1980, Anton and Julia Johnson purchase a home for $400,000. They put $80,000 down and obtain a $320,000, 30-year mortgage secured by their home. In 1996, the house is worth $500,000 and $250,000 is the principal balance remaining on the loan. In 1996, to take advantage of lower interest rates the Johnsons refinance and obtain a $360,000, 20-year mortgage. They use $250,000 to pay off the old mortgage, $90,000 as a down payment on a summer home, and the remaining $20,000 to pay for their daughter's college tuition. They file a joint return.

The interest on up to $250,000 of the debt incurred to pay off the old mortgage is fully deductible; the amount equals the outstanding balance immediately before refinancing. The $90,000 used as a down payment on a summer home is treated as home acquisition debt. Interest paid on this amount is fully deductible; the amount was used to buy a second home and it does not exceed the $1 million ceiling when added to the $250,000 mortgage on the first home. The $20,000 used towards their daughter's college tuition is treated as home equity debt. The interest on this amount is fully deductible; the amount is less than the $100,000 home equity debt ceiling.

Had the Johnsons used $110,000 for college tuition, to buy a new car, and pay off credit card debt, only the interest paid on up to $100,000 of debt would be deductible; interest on the $10,000 excess debt would have been treated as nondeductible personal interest.

POINTS PAID ON REFINANCING

The IRS does not allow a current deduction for points on a refinanced mortgage. According to the IRS, the points must be deducted ratably over the loan period, unless part of the new loan is used for home improvements. Thus, if you pay points of $2,400 when refinancing a 20-year loan on your principal residence, the IRS allows you to deduct only $10 a month, or $120 each full year.

A federal appeals court has rejected the IRS allocation rule where points are paid on a long-term mortgage which replaces a short-term loan; *see* the Court Decision alert at the end of this section.

If part of a refinancing is used for home improvements to a principal residence, the IRS allows a deduction for a portion of the points allocable to the home improvements.

EXAMPLE

In June 1996, Craig Smith refinances his home mortgage, which has a principal of $80,000 outstanding. The new loan is for $100,000, payable over 15 years starting in July 1996. Craig uses $80,000 to pay off the old $80,000 balance and the remaining $20,000 is used for home improvements. Assume that at the closing of the new loan, Smith pays points of $2,000 from his separate funds. In the year of payment he may deduct $400 allocable to the 20% of the loan used for home improvements. He may also deduct the ratable portion of the $1,600 balance of the points, which must be deducted over the period of the new loan. The ratable portion is $53 ($1,600 ÷180-month loan term x 6 months in 1996). Thus, Craig's total deduction for points in 1996 is $453 ($400 + $53).

Mortgage ends early. If you are ratably deducting points on a refinanced loan and you refinance again, or the mortgage ends early because you prepay it or the lender forecloses, you can deduct the remaining points in the year the mortgage ends.

COURT DECISION

Current Deduction for Points on Refinancing

Huntsman replaced a three-year loan used to purchase his principal residence with a 30-year mortgage. He deducted $4,400 of points paid on the new mortgage. The IRS and the Tax Court held that the points had to be deducted over the 30-year loan term.

The Federal Appeals Court for the Eighth Circuit disagreed and allowed a full deduction in the year the points were paid. The first loan was temporary and merely a step in obtaining permanent financing for the purchase of the principal residence.

The IRS has announced that in areas outside of the Eighth Circuit, it will continue to disallow full deductions in the year of payment for points paid on refinancings. The Eighth Circuit includes only these states: Minnesota, Iowa, North and South Dakota, Nebraska, Missouri, and Arkansas. In these states, the IRS will not challenge deductions for points on refinancing agreements similar to Huntsman's which replace short-term financing with long-term permanent financing.

In a later case, the Tax Court held that the *Huntsman* exception does not apply where a borrower refinances a long-term mortgage to take advantage of lower interest rates; the points must be deducted over the term of the new mortgage.

¶15.8 "Points"

Lenders sometimes charge "points" in addition to the stated interest rate. The points increase the lender's up-front fees, but in return borrowers generally are charged a lower interest rate over the loan term. Points are either treated as a type of prepaid interest (¶15.14) or as a nondeductible service fee, depending on what the charge covers. If the points qualify as interest, they are deductible over the term of the loan unless they are paid on the purchase or improvement of your principal residence as discussed in this section.

Points are treated as interest if your payment is solely for your use of the money and is not for specific services performed by the lender which are separately charged. Whether a payment is called “points” or a “loan origination fee” does not affect its deductibility if it is actually a charge for the use of money. The purpose of the charge—that is, for the use of the money or the services rendered—will be controlling. For example, you may not deduct points that are fees for services, such as appraisal fees, preparation of a mortgage note or deed of trust, settlement fees, notary fees, abstract fees, commissions, and recording fees.

If you are *selling* property and you assume the buyer’s liability for points, do not deduct the payment as interest but include it as a selling expense that reduces the amount realized on the sale.

DEDUCTION FOR POINTS ON PURCHASE OR IMPROVEMENT OF PRINCIPAL RESIDENCE

Points are generally treated as prepaid interest (¶15.14) that must be deducted over the period of the loan. However, there is an exception for points you pay on a loan to buy or improve your principal residence. The points on such loans are deductible in the year paid if these tests are met: (1) the loan is secured by your principal residence; (2) the charging of points is an established business practice in the geographic area in which the loan is made; (3) the points charged do not exceed the points generally charged in the area; (4) the amount of points is computed as a percentage of the loan and specifically earmarked on the loan closing statement either as “points,” loan origination fees, or “loan discount”; and (5) you pay the points directly to the lender; *see* “Points withheld from the principal,” below.

Points paid by seller are deductible by buyer. The seller's payment is treated as an adjustment to the purchase price which the seller gives to you as the buyer and which you then turn over to the lender to pay off the points. You must reduce your cost basis for the home by the seller-paid points.

Points withheld from the principal. Points withheld from the principal of a loan used to buy your principal residence are treated as if you paid them directly to the lender, if, at or before closing, you have made a down payment, escrow deposit, or earnest money payment that is at least equal to the amount of points withheld. These payments must have been from your own funds and not from funds that have been borrowed from the lender as part of the overall transaction.

If the loan is used to *improve* your principal residence, the points are not immediately deductible if withheld from the loan principal. You must pay the points with funds that have not been obtained from the lender to claim the full deduction in the year of payment. Otherwise, the deduction must be spread over the loan term.

Points on second home. If you pay points on a mortgage secured by a second home or a vacation home, the points are not fully deductible in the year of payment; you must claim the deduction ratably over the loan term.

CAUTION

Points Reported to the IRS

Points you paid in 1996 on the purchase of your principal residence will be reported to the IRS by the lender on Form 1098 if they meet the five tests explained earlier. Seller-paid points are also included on Form 1098. Form 1098 is used by the IRS to check on the deduction you claim for points on Line 10 of Schedule A. Points paid on an improvement loan for your principal residence are deductible on Line 12 of Schedule A if they meet the tests; they are not shown on Form 1098.

Points paid on refinancing. The IRS does not allow a current deduction for points on a refinanced mortgage (*see* ¶15.7 for further information).

Deduct balance of points if mortgage ends early. If you are deducting points over the term of the loan because a full first-year deduction is not allowed, you are allowed to deduct the balance in the year the mortgage ends, such as when you refinance or prepay the loan, or the lender forecloses. For example, if you refinanced your mortgage in 1992 and paid points, those points had to be amortized over the loan term (¶15.7). If in 1996 you refinance again and pay points again, the balance of the points from the 1992 loan are deductible on your 1996 return, and the points on the new loan must be amortized over the loan term.

¶15.9 Cooperative and Condominium Apartments

Cooperative apartments. If you are a tenant-stockholder of a cooperative apartment, you may deduct your portion of:

Interest paid by the cooperative on its debts, provided you do not pay interest on more than two residences; *see* ¶15.1. This includes your pro rata share of the permanent financing expenses (points) of the cooperative on its mortgage covering the housing project.

Taxes paid by the cooperative (¶16.6). However, if the cooperative does not own the land and building but merely leases them and is required to pay real estate taxes under the terms of the lease, you may not deduct your share of the tax payment.

In some localities, such as New York City, rent control rules allow tenants of a building converted to a cooperative to remain in their apartments even if they do not buy into the co-op. A holdover tenant may prevent some co-op purchasers from occupying an apartment. The IRS ruled that the fact that a holdover tenant stays in the apartment will not bar the owner from deducting his or her share of the co-op’s interest and taxes.

Condominiums. If you own an apartment in a condominium, you have a direct ownership interest in the property and are treated, for tax purposes, just as any other property owner. You may deduct your payments of real estate taxes and mortgage interest. You may also deduct taxes and interest paid on the mortgage debt of the project allocable to your share of the property. The deduction of interest from condominium ownership is also subject to the two-residence limit of ¶15.1. If your condominium is used part of the time for rental purposes, you may deduct expenses of maintenance and repairs and claim depreciation deductions subject to the rules of ¶9.7.

¶15.10 Investment Interest Limitations

Interest paid on margin accounts and debts to buy or carry other investments is deductible up to the amount of net investment income on Schedule A. If you do not have investment income such as interest or dividends, you may not deduct investment interest. Investment interest in excess of net investment income may be carried forward and deducted from next year's net investment income.

You compute the deduction for investment interest on Form 4952, which must be attached to Form 1040. The deduction is *not* subject to the 3% reduction of itemized deductions if your adjusted gross income exceeds $117,950 ($58,975 if married filing separately); *see* ¶13.8.

What is investment interest? It is all interest paid or accrued on debts incurred or continued to buy or carry investment property such as interest on securities in a margin account. However, interest on loans to buy tax-exempt securities is not deductible; *see* ¶15.11.

Investment interest does not include any qualified residence interest (¶15.1), production period interest that is capitalized (¶16.4), or interest related to a passive activity.

Investment property includes property producing portfolio income (interest, dividends, or royalties not realized in the ordinary course of business) under the passive activity rules of Chapter 10, and property in activities that are not treated as passive activities, even if you do not materially participate, such as working interests in oil and gas wells.

Passive activity interest is not investment interest. Interest expenses incurred in a passive activity such as rental real estate (¶10.1), or a limited partnership or S corporation in which you do not materially participate (¶10.6), are taken into account on Form 8582 when figuring net passive income or loss. This includes interest incurred on loans used to finance your investment in a passive activity. Do not treat passive activity interest as investment interest on Form 4952.

However, interest expenses allocable to *portfolio* income (non–business activity interest, dividends, or royalties) from a limited partnership or S corporation are investment interest and not passive interest. The investment interest will be listed separately on Schedule K-1 received from the partnership or corporation.

Interest on loans to buy market discount bonds and Treasury bills. Limits apply to the deduction for interest on loans used to buy or carry market discount bonds (¶4.20) and Treasury bills (¶4.27) acquired after July 18, 1984.

Interest on debts to purchase or carry straddles is not deductible unless the straddle is a hedging transaction; *see* ¶30.9.

COMPUTING THE DEDUCTION

Deductible investment interest is limited to net investment income. Net investment income is the excess of investment income over investment expenses. The key terms *investment income* and *investment expenses* are defined below.

Investment income. Investment income is generally gross income from property held for investment, such as interest, dividends, annuities, and royalties. Income or expenses considered in figuring profit or loss of a passive activity (Chapter 10) is not considered investment income or expenses. Property subject to a net lease is not treated as investment property, as it is within the passive activity rules.

If you have net capital gains (¶5.2) from the sale of investment property (such as stocks or mutual-fund shares), you must specifically elect to include such net capital gains as investment income on Form 4952. If you make this election, and your top tax bracket exceeds 28%, there is this tradeoff: net capital gains eligible for the 28% maximum capital gains rate (¶5.2) must be reduced by the amount of the net capital gains treated as investment interest on Form 4952.

Should you elect to include net capital gains as investment income on Form 4952? If your net investment income without net capital gains is less than your investment interest expense, you should decide whether you want an immediate tax reduction for 1996 from a higher interest deduction. If you do, then, by making the election, your increased interest deduction has the effect of avoiding tax on the amount of capital gain included as investment income on Form 4952.

If, however, you figure that a carryover of investment interest to 1997 or later years will provide a larger tax savings than the election would give for 1996, then you should not make the election. Without the election, you can carry over to succeeding years the currently nondeductible interest in excess of net investment income. If you expect your top tax bracket in 1997 to exceed your 1996 bracket, you may get a larger tax savings by using a carryover to offset income that would otherwise be taxed at the higher 1997 rate. Furthermore, if you project that in 1997 your top rate will exceed 28% and that you will have sufficient non–capital gain investment income to offset the carryover of interest, a carryover could offset investment income subject to a regular rate exceeding the 28% ceiling on net capital gains.

In making your decision, also consider the investment value of receiving a current tax savings, as opposed to a potential savings in a later year.

Investment expenses. There are expenses, other than interest, directly connected with the production of investment income. However, for purposes of determining net investment income, only those investment expenses (other than interest) allowable after figuring the 2% floor for miscellaneous itemized deductions (¶19.24) are taken into account. The 2% floor will bar a deduction for some of the miscellaneous itemized deductions. For purposes of this net investment income computation, assume that miscellaneous itemized deductions other than investment expenses are disallowed first.

Net investment income. Reducing investment income by investment expenses gives you net investment income. Your deduction for investment interest expenses is limited to this amount; any excess interest expense for 1996 may be carried over to 1997, as discussed below.

Where to enter the deduction on your return. The deduction figured on Form 4952 is generally entered on Line 13 of Schedule A as investment interest. However, if the interest is attributable to royalties, you may have to enter the interest on Schedule E; follow the Form 4952 instructions. Furthermore, there is an additional complication if you have investment interest for an activity for which you are not "at risk" (Chapter 10). After figuring the investment interest deduction on Form 4952, you must enter the portion of the interest that is attributable to the at-risk activity on Form 6198. The amount carried over to Form 6198 is subtracted from the investment interest deduction claimed on Form 4952.

Carryover to 1997. Investment interest in excess of net investment income for 1996 may be carried forward to 1997 and is deductible in 1997 to the extent that when added to 1997 investment interest expenses it does not exceed net investment income.

EXAMPLE

For 1996, Larry Jones has $10,000 of investment income from interest and dividends. He has investment expenses, other than interest, of $3,200, after taking into account the 2% floor on miscellaneous itemized deductions. His investment interest expense from securities margin account loans is $8,000. Jones also has income of $2,000 from a passive partnership investment.

Jones's net investment income is $6,800: $10,000 of investment income *less* $3,200 of non-interest investment expenses. The passive activity income from the partnership is not included in investment income.

Jones's investment interest deduction for 1996 is limited to the $6,800 of net investment income. The $1,200 of investment interest in excess of net investment income ($8,000 – $6,800) is carried forward to 1997.

¶15.11 Debts To Carry Tax-Exempt Obligations

When you borrow money in order to buy or carry tax-exempt bonds, you may not deduct any interest paid on your loan. Application of this disallowance rule is clear where there is actual evidence that loan proceeds were used to buy tax-exempts or that tax-exempts were used as collateral. But sometimes the relationship between a loan and the purchase of tax-exempts is less obvious, as where you hold tax-exempts and borrow to carry other securities or investments. IRS guidelines explain when a direct relationship between the debt and an investment in tax-exempts will be inferred so that no interest deduction is allowed. The IRS will *not* infer a direct relationship between a debt and an investment in tax-exempts in these cases:

1. The investment in tax-exempts is not substantial. That is, it is not more than 2% of the adjusted basis of the investment portfolio and any assets held in an actively conducted business.
2. The debt is incurred for a personal purpose. For example, an investor may take out a home mortgage instead of selling his tax-exempts and using the proceeds to finance the home purchase. Interest on the mortgage is deductible under the rules of ¶15.1.
3. The debt is incurred in connection with the active conduct of a business and does not exceed business needs. But if a person reasonably could have foreseen when the tax-exempts were purchased that he or she would have to borrow funds to meet ordinary and recurrent business needs, the interest expenses are not deductible.

The guidelines infer a direct relationship between the debt and an investment in tax-exempts in this type of case: An investor in tax-exempts has outstanding debts not directly related to personal expenses or to his or her business. The interest will be disallowed even if the debt appears to have been incurred to purchase other portfolio investments. Portfolio investments include transactions entered into for profit, including investments in real estate, which are not connected with the active conduct of a business; *see* the Example on the next page.

Mutual funds. If you receive tax-exempt interest dividends from a mutual fund during the year, you may deduct interest on a loan used to buy or carry the mutual fund shares only to the extent it can be allocated to taxable dividends you also receive.

EXAMPLE

An investor owning $360,000 in tax-exempt bonds purchased real estate in a joint venture, giving a purchase money mortgage and cash for the price. He deducted interest on the mortgage. The IRS disallowed the deduction, claiming the debt was incurred to carry tax-exempts. A court allowed the deduction. A mortgage is the customary manner of financing such a purchase. Furthermore, since the purchase was part of a joint venture, the other parties' desires in the manner of financing had to be considered.

¶15.12 Earmarking Use of Loan Proceeds

The IRS has set down complex record keeping and allocation rules for claiming interest deductions on loans used for business or investment purposes, or for passive activities. The rules deal primarily with the use of loan proceeds for more than one purpose and the commingling of loan proceeds in an account with unborrowed funds. The thrust of the rules is to base deductibility of interest on the *use* of the borrowed funds. The allocation rules do not affect mortgage interest deductions on loans secured by a qualifying first or second home; *see* ¶15.1.

To safeguard your investment and business interest deductions, you must earmark and keep a record of your loans. You should avoid using loan proceeds to fund different types of expenditures. Keep separate accounts for business, personal, and investment borrowing. For example, if you borrow for investment purposes, keep the proceeds of the loan in a separate account and use the proceeds only for investment purposes. Do not use the funds to pay for personal expenses. Furthermore, do not deposit loan proceeds in an account funded with unborrowed money, unless you intend to use the proceeds within 30 days of the deposit. By following these directions, you can pinpoint your use of the proceeds to a specific expenditure, such as for investment, personal, or business purposes, and the interest on the loan may be treated as incurred for that purpose. The 30-day rule is discussed below.

The IRS treats undisbursed loan proceeds deposited in an account as investment property, even though the account does not bear interest. When proceeds are disbursed from the account, the use of the proceeds determines how interest is treated; see Examples 1 and 2 later in this section.

30-day disbursement rule. If you deposit borrowed funds in an account with unborrowed funds, a special 30-day rule allows you to treat payments from the account as made from the loan proceeds. Where you make more than one disbursement from such an account, you may treat any expenses paid within 30 days before or after deposit of the loan proceeds as if made from the loan proceeds. Thus, you may allocate interest on the loan to that disbursement, even if earlier payments from the account have been made; *see* Example 3. If you make the disbursement after 30 days, the IRS requires you to allocate interest on the loan to the first disbursement; *see* Example 4. Furthermore, if an account includes only loan proceeds and interest earned on the proceeds, disbursements may be allocated first to the interest income and then to the loan proceeds.

Allocation period. Interest is allocated to an expenditure for the period *beginning* on the date the loan proceeds are used or treated as used, and *ending* on the earlier of either the date the debt is repaid or the date it is reallocated.

Accrued interest is treated as a debt until it is paid, and any interest accruing on unpaid interest is allocated in the same manner as the unpaid interest is allocated. Compound interest accruing on such debt, other than compound interest accruing on interest that accrued before the beginning of the year, may be allocated between the original expenditure and any new expenditure from the same account on a straight-line basis. That is done by allocating an equal amount of such interest expense to each day during the taxable year. In addition, you may treat a year as *twelve 30-day months* for purposes of allocating interest on a straight-line basis.

Payments from checking account. A disbursement from a checking account is treated as made at the time the check is written on the account, provided the check is delivered or mailed to the payee within a reasonable period after the writing of the check. You may treat checks written on the same day as written in any order. A check is presumed to be written on the date appearing on the check and to be delivered or mailed to the payee within a reasonable period thereafter. However, the presumption may not apply if the check does not clear within a reasonable period after the date appearing on the check.

Change in use of property. You must reallocate interest if you convert debt-financed property to a different use; for example, when you buy a business auto with an installment loan, interest paid on the auto is business interest, but if during the year you convert the auto to personal use, interest paid after the conversion is personal interest.

Order of repayment. If you used loan proceeds to repay several different kinds of debt, the debts being repaid are assumed to be repaid in the following order: (1) personal debt; (2) investment debt and passive activity debt other than active real estate debt; (3) debt from a real estate activity in which you actively participate; (4) former passive activity debt; and (5) business debt. *See* Example 5. Payments made on the same day may be treated as made in any order.

EXAMPLES

1. On January 1, you borrow $10,000 and deposit the proceeds in a non-interest-bearing checking account. No other amounts are deposited in the account during the year and no part of the loan is repaid during the year. On April 1, you invest $2,000 of the proceeds in a real estate venture. On September 1, you use $4,000 to buy furniture.

   From January 1 through March 31, interest on the entire undisbursed $10,000 is treated as investment interest. From April 1 through August 31, interest on $2,000 of the debt is treated as passive activity interest, and interest on $8,000 of the debt is treated as investment interest. From September 1 through December 31, interest on $4,000 of the debt is treated as personal interest; interest on $2,000 is treated as passive activity interest; and interest on $4,000 is treated as investment interest.
2. On September 1, you borrow money for business purposes and deposit it in a checking account. On October 15, you disburse the proceeds for business purposes. Interest incurred on the loan before the disbursement of the funds is treated as investment interest expense. Interest starting on October 15 is treated as business interest. However, you may elect to treat the starting date for business interest as of the first of the month in which the disbursement was made—that is, October 1—provided all other disbursements from the account during the same month are similarly treated.
3. On September 1, you borrow $5,000 to invest in stock and deposit the proceeds in your regular checking account. On September 10, you buy a TV and stereo for $2,500 and on September 11 invest $5,000 in stock, using funds from the account. As the stock investment was made within 30 days of depositing the loan proceeds in the account, interest on the entire loan is treated as incurred for investment purposes.
4. Same facts as in Example 1, but the TV and stereo were bought on October 1 and the stock on October 31. As the stock investment was not made within 30 days, the IRS requires you to treat the purchase of the TV and the stereo for $2,500 as the first purchase made with the loan proceeds of $5,000. Thus, the 50% of loan interest that is allocated to the stereo purchase is nondeductible.
5. On July 12, Smith borrows $100,000 and immediately deposits the proceeds in an account. He uses the proceeds as follows:

August 31	$40,000 for passive activity
October 5	$20,000 for rental activity
December 24	$40,000 for personal use

On January 19 of the following year, Smith repays $90,000. Of the repayment, $40,000 is allocated as a repayment of the personal expenditure, $40,000 of the passive activity, and $10,000 of the rental activity. The outstanding $10,000 is treated as debt incurred in a rental activity.

¶15.13 Year To Claim an Interest Deduction

As a cash-basis taxpayer, you deduct interest in the year of payment except for prepayments of interest; *see* ¶15.14. Giving a promissory note is not considered payment. Increasing the amount of a loan by interest owed, as with insurance loans, is also not considered payment and will not support a deduction. If a person pays your interest obligation with the understanding you will repay him or her, you take the deduction in the year the interest is paid, not when you repay him or her. However, an accrual-basis taxpayer generally deducts interest in the year the interest accrues; *see* ¶40.2.

Using Borrowed Funds To Pay Interest

To get an interest deduction you must pay the interest; you may not claim a deduction by having the creditor add the interest to the debt. If you do not have funds to pay the interest, you may borrow money to pay the interest. The borrowed funds must be from a different creditor. The IRS disallows deductions where a debtor borrows from the same creditor to make interest payments on an earlier loan. The second loan is considered a device for getting an interest expense deduction without actually making payments. Courts tend to side with the IRS.

Here is how a cash basis taxpayer treats interest in the following situations:

On a life insurance loan, where proceeds are used for a deductible (nonpersonal) purpose, you claim a deduction in the year in which the interest is paid. You may not claim a deduction when the insurance company adds the interest to your debt. You may not deduct your payment of interest on an insurance loan after you assign the policy.

On a margin account with a broker, interest is deductible in the year in which it is paid or your account is credited after the interest has been charged. But an interest charge to your account is not payment if you do not pay it in cash or the broker has not collected dividends, interest, or security sales proceeds which may be applied against the interest due. Note that the interest deduction on margin accounts is subject to investment interest limitations; *see* ¶15.10.

For partial payment of a loan used for a deductible (nonpersonal) purpose, interest is deductible in the year the payment is credited against interest due. When a loan has no provision for allocating payments between principal and income, the law presumes that a partial payment is applied first to interest and then to principal, unless you agree otherwise. Where the payment is in full settlement of the debt, the payment is applied first to principal, unless you agree otherwise. Where there is an involuntary payment, such as

that following a foreclosure sale of collateral, sales proceeds are applied first to principal, unless you agree to the contrary. *See also* ¶15.12 for the effect of payments on the allocation of debt proceeds.

Note renewed. You may not deduct interest by merely giving a new note. You claim a deduction in the year the renewed note is paid. The giving of a new note or increasing the amount due is not payment. The same is true when past due interest is deducted from the proceeds of a new loan; this is not a payment of the interest.

¶15.14 Prepaid Interest

If you prepay interest on a loan used for *investment* or *business* purposes you may not deduct interest allocable to any period falling in a later taxable year. The prepaid interest must be deducted over the period of the loan, whether you are a cash basis or accrual basis taxpayer.

Points paid on the purchase of a *principal residence* are generally fully deductible in the year paid; *see* ¶15.8. Points paid on refinancing generally are not deductible; *see* ¶15.7.

Treatment of interest included in a level payment schedule. Where payments of principal and interest are equal, a large amount of interest allocated to the payments made in early years of a loan will generally not be considered prepaid interest. However, if the loan calls for a variable interest rate, the IRS may treat interest payments as consisting partly of interest, computed under an average level effective rate, and partly of prepaid interest allocable to later years of the loan. An interest rate which varies with the "prime rate" does not necessarily indicate a prepaid interest element.

When you borrow money for a deductible purpose and give a note to the lender, the amount of your loan proceeds may be less than the face value of the note. The difference between the proceeds and the face amount is interest discount. For loans that do not fall within the OID rules of ¶4.18, such as loans of a year or less, interest is deductible in the year of payment if you are on the cash basis. If you use the accrual basis, the interest is deductible as it accrues.

EXAMPLE

In February 1995, you borrow $1,000 for an investment and receive $900 in return for your $1,000 note. You repay the full loan in January 1996. You are on the cash basis. You do not deduct the interest of $100 when the note is given. The $100 interest is deductible when the loan is paid in 1996. If the loan proceeds were used for personal purposes, none of the interest is deductible in 1996.

For loans that fall within OID rules, your lender should provide a statement showing the interest element and the tax treatment of the interest.